The impact of Regulatory Reform on the

European Banking Sector

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Ladies, Gentlemen,

You have asked me to present the "consultant's view" of the impact of the latest regulatory Reform on the European Banking sector. I am speaking as former consultant. The subject being very vast, I have definitively taken a somewhat narrow and arbitrary angle of discussion. My remarks will pertain to the business impact of the reforms on banks and on their strategic posture. The observations will be put in a somewhat broader context than the regulatory reforms implemented in 2014 and will try to draw some conclusions for the future. Always bearing in mind, as someone famously said, that "forecasts are particularly difficult, especially when they pertain about the future".

My thesis is that the regulatory reforms have put in place a fundamentally new, transformative and comprehensive framework to guarantee the stability of the financial sector but I would like to challenge this audience by mentioning several overlooked side effects – with potentially negative long term consequences – that will need to be carefully and equally forcefully addressed. To support my message, I will cover successively three points:

- The overall business impact of the regulatory reforms of the last years
- A high level assessment of the economic impact that it has had on banks
- Four critical questions for regulators and leaders pertaining to potentially negative side effects to be addressed

BUSINESS IMPACT

The reforms of the last years were single mindedly focused on reducing the risk (both individual and systemic) of banks.

If we look at the first order business effect of these reforms on banks (and it may still be early on some dimensions), one can easily indicate that they have reached their goal – sometimes faster than one might have thought.

The **most egregious risky businesses of banks** have been if not completely eliminated, certainly brought to measure. Events like the "London Whale" at JPMorgan Chase a couple of years ago have almost disappeared; some will certainly happen again, but this type of "tail risk" has certainly be greatly reduced. This has hit profoundly capital market activities of banks and created widespread restructuring of these businesses, including at the biggest institutions. The profitability of several of these businesses is now below the cost of capital – if one includes all the direct and indirect charges.

Interconnectedness is better controlled. Both the relative size of interbank activities and exposure to the (domestic) public sector have been reduced significantly. Paradoxically, this has created a **MORE FRAGMENTED** European market, instead of a more integrated one. More on that later.

Business models have been profoundly altered toward more disintermediation of the financial flows, strengthening the role of financial markets, at the expense of banks (ironically this decreases the ability of Central banks and regulators to control financial stability). Balance sheets have been reduced; the financial sector aggregated balance sheet is now a much a smaller share of GDP. One important nuance: **liquidity of many markets has decreased** as intermediaries are now heavily penalized for holding inventories. Financing of the economy (especially households and small companies) is still firmly in the hands of banks – based on their better risk assessment capabilities and their ability to charge the cost of capital to these clients.

(Credit) margins have increased to reflect both the higher cost of capital from the regulation and, as is normal, during a phase of lowering interest rates levels. Although it is difficult to distinguish the effect of regulation and interest rate levels, it is probably fair to say that there has been a (positive for banks, negative for clients) repricing of financial services.

Compliance and risk management have become "front and center" not only as function in their own right, but also as a preoccupation in all functions of financial institutions. The net effect is certainly positive – even if progress still needs to be made in the "culture dimension" by opposition to the rule-based application.

In summary, the changes to the banking sector have been profound and probably more rapid than many had expected. Significant progress has been made in what was aimed at – less risk, more control.

Now let's turn to the economic and financial implications of these changes for banks.

FINANCIAL IMPLICATIONS

The reforms were designed to strengthen the resilience of banks toward unexpected shocks. Indeed, the sector had become very vulnerable pre-2008. Just one measure sums up that historical risk: the leverage ratio of banks had never been more stretched (meaning equity to balance sheet had never been so low) in history – less than 2%.

Again here, progress has been made on many fronts. Overall **capitalization of banks** (be it measured with a crude measure of leverage, CET1 or any broader measure) **has substantially increased** and is growing further – even after the major impairments provoked by the crisis of 2008. This is obviously positive in terms of risk absorption capacity, although profitability is suffering (we will come back later to this).

Funding stability and liquidity have also increased. Just looking at one crude measure – Loans to deposits – progress has been spectacular, with most European close to or below 100 %.

The big negative – and this has been heavily documented – is the **profitability impact.** Direct cost of risk management and compliance – recurrent management costs, investments notably in systems, fines, …. - has exploded and continues to grow. Indirect cost is also becoming very high – I joked with one of my former colleagues who is now a supervisor abroad that when we both advised 10 years ago the institution he is now heading it had only … one tenth of the employees it has today; we both doubted that they are 10 times more effective today than then!

Despite the credit repricing, **revenues have been hit (through lower volumes) in the better performing activities** of banks, exposing an old problem: many client-related activities have simply not been profitable or insufficiently so for a long time. If we are honest with ourselves, the current decline in headcount in banks is – unfortunately – NOT yet due to the digitalization in main order; it is simply the reflection that profits are low and that one needs to adjust costs!

At European level, the effect is pretty dramatic. European banks earned 3.2% ROE on average in 2014; 2015 will not have been much better – and yet worse is to come. It is not clear at all that we have reached a sustainable balance between risk management and profitable business in Europe.

FOUR (LESS OBVIOUS) QUESTIONS

If one can relatively easily agree that the first order consequences of the regulatory reforms of the last 8 years have been positive for risk management on average, they may yield over time four unintended second order consequences that political and business leaders and supervisors should think through:

1. **Has catastrophic "tail" risk increased?** The reforms intended to impose a tighter risk management model on banks – so reducing average risk – but could it have increased the exposure to big "monster" events? There are some indications that it might. Most risk models and risk management approaches are now converging – and becoming very similar. Everybody is looking at the same topics. Regulators are becoming increasingly part of business decisions (and may become liable for some of them!). Paradoxically this reduces the overall resilience of the system to huge unforeseen risks – that nobody has anticipated. In a sense "randomness" has some merits. None of these catastrophic risks has (yet) occurred. But the law of risks is that of a "waterbed": if you push it out somewhere, it will pop up somewhere else. Nothing is worse than to have created a sense of security and of "no-risk": this does not exist, and actually may breed complacency.
2. **Have we not inadvertently created other risks?** The first area of concern is obviously the attractiveness of being a **"non-regulated" financial entity**. The size of the non-regulated financial sector has never been higher today relative to regulated banks. True they resisted quite well to the shocks of the last years; but is the declining profitability of the hedge funds and private equity sectors not a warning signal that problems may occur? Are they really as insulated from the real economy as we like to think?
   Another inadvertently created risk may be **with those that one wanted to protect**: ordinary savers and investors. For example, it is now widely admitted that the most recent MIFID reforms are cutting off advice from those that need the most (middle income savers), simply because the compliance cost and risk does not justify the effort from banks anymore; worse, some recent decisions penalize the open architecture investment advice to the benefit of captive models. Is this really what we wanted? This is not prudential banking regulatory reform but it has implications on business models.
3. **Have we pushed "rule based" supervision too far?** This is obviously a controversial point – could we have done differently, will be argued? Yet, there are worrying signals around two dimensions. First, we are noticing a **growing level of resignation and "bureaucratization"** in risk management: "I have ticked the boxes, so I am fine", is what we hear, by opposition to "I have thought through the risks in depth, I know the big sensitivities and I have put in place the measures to take". Second, we are watching a **growing risk aversion by management**; this is worrying as innovation is really stifled and actually shifting outside the realm of the supervised activities. We need a healthy, profitable and growing banking sector. We may have pushed too hard the "risk health" at the expense of other dimensions.
4. **Finally, and probably the most concerning issue, have we not too aggressively applied an Anglo-saxon model on what is essentially a banking sector with very different constraints**

in Western Europe; are we not penalizing unduly our banks in a global competition? As you can hear, this is probably our biggest mid-term question. First the facts: the European banking sector earned 3.2 % ROE in 2014, the US 8.5 % ROE. Markets have a clear judgement: market to book is around 1 in Europe, closer to 1.5 in the US, showing their (lower) lack of trust in sustained economic returns of the European banks. European banks appear today much weaker than their anglo-saxon rivals; if tomorrow US banks decided to take over our biggest European banks (which they have mysteriously not yet decided to do), there is nothing that would prevent them from buying them all up. Is this what we want?

As also mentioned earlier, **European banking markets are even more fragmented** than they used to be; regulators take now the view that "big is bad" and the incomplete deposit protection and resolution regimes show clearly that the next problem will still have to be shouldered by individual States. If we don't want to create a true "European market for financial services", why do we have the EURO then? Do we still want to see the **huge spreads in lending rates between EU member countries** that still prevail for local borrowers?

Fundamentally – and this differentiates the Eurozone from the UK and the US – we are living with a surplus of financial flows to the financial sector because of our excess on the current account of the balance of payments, whereas the UK and US have been living with deficits for most of the last 50 years. This drives a fundamentally different dynamic: shortage of funds in the UK and the US, excess of liquidity in the Eurozone. Securities markets have always been deeper in the UK and the US. We should be addressing this challenge by **creating mechanisms for deeper financial markets**, which the current focus on risk management has completely obliterated – and our Governments should play a critical role in improving this situation as this will not happen by itself! This is a big subject that would deserve a longer debate.

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In closing, the regulatory reforms of the last 8 years have clearly improved the overall resiliency of banks. One should now ask oneself how to correct some of the (big) unintended second order consequences of these reforms.

Thank you for your attention.